DESIRABLE SCOPE AND METHOD OF FEDERAL REGULATION OF RAILROAD SECURITIES

By Max Thelen

In preparing a paper on "Desirable Scope and Method of Federal Regulation of Railroad Securities," as I have been requested to do, it is necessary to make a number of assumptions. The writer of such a paper must assume for the purpose of the paper that railroads will remain in private ownership.

It may be assumed, furthermore, that it is not necessary in this paper to demonstrate the necessity for public regulation of railroad securities. Heretofore, it has at times been urged that railroad securities have nothing to do with the regulation of railroad rates, service or facilities and that, accordingly, there is no necessity for public regulation of their issue. It seems clear, however, that a railroad whose financial structure is unsound not merely has great difficulty in maintaining reasonable rates and adequate service but also finds it practically impossible to secure new funds for necessary additional capital expenditures. The predicament of the railroads which, even before the outbreak of the war, found themselves unable to secure the additional funds urgently needed for the enlargement of terminals, the construction of double tracks, the purchase of additional locomotives and freight cars and for other capital purposes was largely caused by excessive security issues or an unhealthy preponderance of funded indebtedness over capital stock. Our failure in the past to provide adequate regulation over the security issues and the financial structures of these railroads is largely responsible for their present condition. Our difficulty has been not too much but too little regulation.

The title of this paper presupposes that, to some extent at least, federal regulation of railroad securities is desirable or necessary but that the scope and method of such regulation are open to discussion. In the brief and sketchy manner made necessary by the limits of this paper I shall address myself herein specificially to the desirable scope and the desirable method of the regulation of railroad securities by the federal government.

The subject will be considered under the following heads:

1. Federal versus state control
2. Federal incorporation
3. Control versus publicity
4. Proposed statute

1. FEDERAL VERSUS STATE CONTROL

Heretofore the federal government has made no provision for the regulation of the issue of railroad securities. In the absence of action by the federal government, twenty-one states have provided for such regulation by their respective railroad or public service commissions.[1]

In determining whether regulation in a given field of railroad activity should be exercised by the federal government or by the state governments, I have always been of the opinion that the federal government should do whatever the federal government can best do for our people and that the state governments should do whatever they can best do. The test is the good of our people as a whole and not whether a favor shall be extended to the federal government or to the state governments.

Applying this test to the railroad situation, I believe that the regulation of local service, facilities and police regulations can best be done by local authorities. The same conclusion follows, in my opinion, with reference to local rates, with the proviso that legislation should be enacted by the federal government providing for coöperation between the Interstate Commerce Commission and the affected state commissions in the so-called Shreveport situations, involving alleged discrimination between interstate rates and intrastate rates.

However, applying the same test to the issue of railroad securities I have long since reached the conclusion that authority over the issue of securities of railroads engaged in interstate commerce should be exercised exclusively by the federal government. This conclusion is based not merely on an abstract study of the situation but also on an experience of five years as a member of a state railroad commission charged with the duty of regulating the issues of securi-

[1] For a detailed analysis of what the states have done in regulating railroad securities, see article in this volume: "State Regulation of the Securities of Railroads and Public Service Companies." [EDITOR.]

ties of all classes of public utilities, including railroads engaged in interstate commerce.

The reasons for this conclusion may be stated very briefly. Referring first to capital stock, no state can control the issue of stock by a railroad company incorporated in another state. In order to escape regulation of the issue of its capital stock it is now only necessary for a railroad company to incorporate in some state which does not provide for regulation of the issue of the capital stock of railroad companies. The only way to meet this situation is to provide for regulation by the federal government. Referring now to bonds, efficient and economical financing requires that railroad obligations evidenced by bonds shall constitute a lien upon the property of the railroad, irrespective of state lines. As a practical matter, financing in pieces by state lines is not possible. To provide that application for authority to issue railroad bonds must be made to each state in which any portion of the property to be mortgaged is located is not merely dilatory and cumbersome but also leaves open the door to differences of opinion between the authorities of the various states, which differences may result in the defeat of the entire proposed issue. The only prompt and satisfactory control over the issue of railroad bonds is the establishment of exclusive control by the federal government in a single regulatory body.

A number of bills introduced in Congress during the last few years and providing for some measure of control by the federal government over railroad security issues have provided, in effect, that the control by the federal government shall be concurrent with continuing control by the respective state governments. The result of such legislation would be to add one more commission to those already exercising control, and thereby to introduce additional delays and increase the possibilities of differences of opinion between the various public regulatory authorities. Such legislation would complicate the situation and would seem to be inadvisable. The only satisfactory solution is exclusive jurisdiction in the federal government with reasonable opportunity to all affected state commissions to appear before the federal authority and to be heard in matters affecting their respective states.

Under the decisions of the Supreme Court of the United States construing federal statutes referring to hours of service, employers'

liability laws, safety appliances and other fields of railroad regulation, I have no doubt of the legal power of Congress to provide for exclusive regulation by the federal government of the security issues of all railroads to any extent engaged in interstate commerce. If the federal government enters this field and indicates its intention that its regulation therein shall be exclusive, the authority of the states to exercise jurisdiction in this field will be effectively excluded. In this respect I agree with the argument presented to the Committee on Interstate and Foreign Commerce of the House of Representatives in February and March, 1914 and to the Committee on Interstate Commerce of the United States Senate in June and July, 1916 by Mr. Alfred P. Thom, speaking as representative of railroads whose earnings constitute 84 per cent of all railroad earnings in the United States.

2. FEDERAL INCORPORATION

The suggestion has recently been made in certain quarters that federal regulation of railroad security issues cannot be made effective without federal incorporation of all the railroads. This suggestion is contrary to the generally accepted view. The conclusive answer to the suggestion is found in the argument of Mr. Thom before the Committee on Interstate and Foreign Commerce of the House of Representatives in 1914 and in the restatement of his legal conclusions made by him in December, 1916 before the Joint Committee of the Senate and House of Representatives.

The power of the federal government to create a federal railroad corporation rests on its authority to establish an agency or instrumentality to carry into effect the powers vested in the government.[2] The federal government cannot, by creating a federal railroad corporation, enlarge the powers possessed by the federal government. Whatever the government can do indirectly through the creation of a corporation as its agent it may do directly as principal without the establishment of the agency. Accordingly, the creation of a federal railroad corporation cannot possibly enlarge such powers as the federal government already possesses to regulate the security issues of railroads engaged in interstate commerce. The creation of federal railroad corporations for this purpose is entirely unnecessary.

[2] *McCullough* v. *Maryland*, 4 Wheat. 316.

As bearing on the regulation of railroad security issues by the federal government, it may be appropriate at this point to draw attention to the fact that under the plan of federal incorporation presented by the railroads to the Joint Congressional Committee it is provided that no railroad shall be permitted, after a certain day, to continue to engage in interstate commerce unless it has taken out a federal charter; that a federal railroad corporation is to take the place of each existing state railroad corporation; and that the federal railroad corporation shall, under this compulsory plan, have the same securities outstanding as are now outstanding against the state railroad corporation. In other words, by compulsion of the federal government, the existing railroad securities, including all the water therein and all the seeds of financial disease resulting from existing unhealthy railroad financial structures, are to be perpetuated in the new federal railroad corporations. That such legislation should be adopted by Congress seems inconceivable.

This paper will proceed on the assumption that federal incorporation of the railroads is entirely unnecessary to the adequate regulation by the federal government of the security issues of all railroads engaged in interstate commerce.

3. CONTROL VERSUS PUBLICITY

Considerable difference of opinion has heretofore existed on the question whether federal control over railroad security issues shall provide merely for publicity or whether it shall provide for affirmative action by the appropriate public authority before such securities may be issued. These two opposing theories are generally referred to as the "publicity" method and the "control" method.

The publicity method provides that before a railroad corporation may issue securities it must file with a designated public authority a statement of the proposed issue and of its financial condition. Having filed such statement the corporation may then issue the proposed securities without action by the public authority. The control method provides that before the railroad corporation may issue its securities it must first receive the approval of a designated public authority.

The publicity method was favored by the Federal Securities Commission, of which President Hadley of Yale University was chairman, and has been advocated by a number of prominent men

in public life, including two former members of the Railroad Commission of Wisconsin. Of all the states of the Union which have provided for control over the issues of railroad securities, Virginia alone has adopted the publicity method. All the other twenty states which have provided for such regulation have adopted the control method. The chief argument advanced by those who favor the publicity method seems to be that under the control method the public authority is either legally or morally bound to authorize rates sufficiently high to yield a return on the security issues authorized by it as well as on all the preceding security issues. As far as the legal question is concerned, I have seen no authority to support the proposition. To remove any doubt on this question, the federal statute could readily provide that nothing therein contained should be construed to imply any guaranty or obligation on the part of the United States with reference to the securities authorized.

Referring to the assumed moral obligation, it seems obvious that in so far as past issues of securities are concerned, made without governmental action, no such assumed obligation can possibly exist. In so far as issues hereafter authorized by the federal government are concerned, it has never been successfully contended that a governmental authority which authorizes such security issues even morally underwrites the success of the corporation. Due weight will, of course, be given to the investment made by the corporation and to the securities from which the funds thus invested are derived. This statement, however, by no means implies that the corporation is relieved from the ordinary chances which every business takes and that the government either legally or morally guarantees the success of the venture or the integrity, under all conditions, of the security issues authorized by it. In California, where the State Commission acts under the "control method," I have never heard the suggestion made that the state is in the position of a guarantor of the security issues authorized by it. I am also advised that in most of the other states which also have the control method no such suggestion has ever been made.

The chief argument in favor of the control method is that the ability of the utility to render adequate service at reasonable rates and to fulfil the requirements of the public for additions, betterments and extensions depends very largely on the soundness and integrity of its financial structure, and that the construction and

maintenance of healthy financial structures for the protection both of the utility and of its patrons imperatively require the affirmative control over security issues which has now been established in most of the leading states of the Union. In my opinion, control over the issue of securities and the disposition of their proceeds is the keystone of the entire arch of public utility regulation. Regulation which merely provides that the utilities shall file a public record of what they intend to do in connection with security issues would not have prevented the wreck of the Chicago and Alton, the New York, New Haven and Hartford, the Frisco or the Rock Island. I consider such regulation to be entirely ineffective and hence worse than no regulation. In my opinion, based on the experience in California and other states of the Union which have undertaken the regulation of the security issues of public utilities, the only effective method of regulation is the control method.

4. PROPOSED STATUTE

I shall now make a number of suggestions with reference to provisions to be contained in a federal statute establishing control of the security issues of railroads engaged in interstate commerce.

In my opinion the control over security issues of such railroads should be vested in the same federal body which regulates, to the extent to which such regulation has been provided, their rates, service and safety and which ascertains the various facts entering into the value of railroad properties. This conclusion not merely seems logical, but also is in accordance with the practice of all the states which have provided for regulation of railroad security issues. In making this suggestion, however, I wish to draw attention to the fact that no branch of public utility regulation requires more prompt action than requests for authority to issue securities, and to suggest that if this authority is vested in the Interstate Commerce Commission, adequate machinery must be provided so that the authority may be promptly exercised.

The statute, in my opinion, should apply to all railroads which are engaged in interstate commerce but should not, for the present, include street railways.

The statute should apply to holding companies as well as to operating companies. I am not in sympathy with the suggestion that the regulation should not apply to railroads which are located

entirely within the limits of a single state. If such railroads are engaged in interstate commerce, as most of them are, they should be just as much subject to regulation of their security issues by the federal government as the railroads whose situation differs only in the fact that they happen to cross a state boundary line. The test, in my judgment, should be whether the railroad is to any extent engaged in interstate commerce and not whether its tracks and ties happen to be located entirely within the boundaries of a single state.

The statute should state the purposes for which railroad securities may be issued. These purposes are generally defined in the state statutes to be the acquisition of property; the construction, completion, extension or improvement of facilities; the improvement or maintenance of service; the discharge or lawful refunding of obligations; and the reimbursement of moneys expended from earnings or from other moneys in the treasury of the utility not secured from the issue of stocks, bonds or other evidences of indebtedness, for any of the aforesaid purposes.

The statute should provide that no railroad corporation subject thereto should have authority to issue any stocks or stock certificates or any bonds, notes running longer than a specified term, or other evidences of indebtedness unless a petition asking authority to make the issue has first been filed with the Interstate Commerce Commission and the Commission has made its order thereon specifying the issue which is authorized, and stating the amount thereof and the purpose or purposes to which the issue or the proceeds thereof may be applied.

I consider it unwise to have the statute specify in detail the contents of the petition. It would be far more desirable, in my opinion, to have the statute provide that applications should be made in such form as the Interstate Commerce Commission may from time to time determine and prescribe and that the Commission should have the power to establish rules and regulations governing the contents of the petition and the procedure in connection therewith. The experience of the states shows the wisdom of a statute unencumbered by unnecessary detail and providing flexible regulation within the definite principles established by the statute.

The statute should provide that notice should be given to the railroad commission or public service commission or public utilities

commission or other appropriate authority of each state in which the petitioner operates, with the right on the part of such states to appear before the Interstate Commerce Commission and to be heard upon the application. The Interstate Commerce Commission should be authorized to give such additional notice as in its judgment is necessary and to hold such hearings as it considers advisable.

The statute should provide that the Commission may by its order grant permission for the issue of securities in the amount applied for, or in a lesser amount, or not at all, and that the Commission should have the right to attach to the exercise of its permission such condition or conditions as it may deem reasonable and necessary. The power of the Commission to impose conditions in its order is a matter of very great importance and should not be overlooked in the framing of the statute.

The Interstate Commerce Commission should be authorized to require the railroad companies, in such form and detail as the Commission may consider advisable, to account for the disposition of the proceeds of securities authorized and to establish rules and regulations to insure the disposition of the proceeds for the purpose or purposes specified in the original order or in such amended or supplemental orders as the Commission may from time to time make.

The statute should provide that the Commission shall have no power to authorize the capitalization of the right to be a corporation, or to authorize the capitalization of any franchise or permit in excess of the amount (exclusive of any tax or annual charge) actually paid to any public authority as the consideration for the grant of the franchise, permit or right. Franchises are granted by public authorities to enable private capital, as agent for the public, to exercise functions which the public itself might directly perform. To have private capital ask public authorities to grant franchises so that such capital may perform important functions as agents of the public and then to have the grantees of such franchises turn around on the public and claim against the public values for the franchises thus conferred is the height of absurdity and injustice. When the federal government undertakes to control the issue of railroad securities it should be careful to insert in the statute appropriate language so as to prevent the capitalization of any such franchises, permits or privileges except to the extent of actual payment made therefor by the grantee of the franchise, permit or privi-

lege to the public authority granting the same. An ounce of prevention is worth a pound of cure.

In order to set at rest definitely the claim that any governmental guaranty, either legal or moral, will follow from authorizations to issue securities, it may be well, although unnecessary, to insert in the statute a clause providing substantially that nothing therein contained shall be construed to imply any guaranty or obligation on the part of the United States.

The statute should provide appropriate penalties for its violation. In my opinion, it is not sufficient to provide that violations or proposed violations may be enjoined and that persons guilty thereof may be fined or imprisoned. I suggest the additional provision found in the California Public Utilities Act, to the effect that any security issued without an order of the commission authorizing the same then in effect shall be void, but that failure in any other respect to comply with the conditions of the order shall not render such security void except as to a corporation or person taking the same otherwise than in good faith and for value and without actual notice.

Closely akin to control over security issues is control over the sales, leases, mortgages, encumbrances, mergers and consolidations of public utility properties. I suggest that the federal statute should provide that no railroad corporation subject thereto should thenceforth sell, lease, assign, mortgage or otherwise dispose of or encumber the whole or any part of its property necessary or useful in the performance of its duties to the public or any franchise or permit or right thereunder, nor by any means whatsoever, direct or indirect, merge or consolidate its property with any other common carrier subject to the Interstate Commerce Act without having first secured from the Interstate Commerce Commission an order authorizing it so to do.

There is nothing unusual or particularly difficult in connection with the exercise of the powers herein suggested to be conferred upon the Interstate Commerce Commission. Such powers are now exercised in the leading states of the Union with reference to railroads and, to a considerable extent, other classes of public utilities. The principles applicable to such control, the proceedings before the commissions, the forms of the orders, the method of reporting the security issues by the utility and the disposition of the proceeds

of such issues and every other factor connected with the problem have been worked out in detail by the various state commissions.

That the exercise of these powers by these states has had a salutary effect in protecting both the public utilities and their consumers and in improving the sale of public utility securities is generally conceded. That necessary public utility development continues unaffected by such regulation is shown by the fact that in California in excess of two hundred and thirty million dollars of new money has been invested in public utility enterprises since March 23, 1912, the effective date of the Public Utilities Act, being the largest amount of such investment in any corresponding period of the state's history.

By reason of the peculiar facts surrounding railroads engaged in interstate commerce, the control of their security issues by the states has not been as prompt, satisfactory and effective as the railroads, their patrons and their investors have the right to expect. For that reason the ineffective control over railroad security issues now established in a portion of the states of the Union should give way to prompt, effective and unified control by the federal government.